United States Court of Appeals

for the Second Circuit

REPLY BRIEF

Signed

76-4134

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

ESTATE OF JOSEPH VATTER, DECEASED,
ANNA VATTER, EXECUTRIX,

Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

B
P/S

ON APPEAL FROM THE DECISION OF THE

UNITED STATES TAX COURT

REPLY BRIEF FOR THE APPELLANT

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The estate's answering brief advances a number of arguments as to why it believes the judgment below should be affirmed, but never fully comes to grips with our argument that the sales of the Arnett Boulevard and Pullman Avenue properties were not "necessary" to settle the estate within the meaning of Section 2053 of the Internal Revenue Code of 1954 and the Regulations thereunder. In a sense, then, this reply brief will be directed as much to what the estate does not assert as to what it does argue.

1. The principal theme of the estate's brief (pp. 5, 12, 14)--that the selling expenses for the Arnett Boulevard and Pullman Avenue properties are allowable estate administration expenses under New York law simply because the executrix and not the trustee sold the properties--is based upon a misunderstanding of the controlling legal principles and ignores the critical question whether the sale was carried out for the purpose of administering the estate. Apparently, it would be the estate's position that the same sales transactions would produce different tax results depending upon who actually sold the properties in a given case. Thus if all three rental properties here had been sold by the trustee instead of by the executrix, under the estate's theory, no deduction would be allowed to the estate, even assuming one of the sales was in fact necessary to generate cash to pay the estate taxes due.

The only case cited by the estate (Br. 11) in support of its theory is Estate of Sternberger v. Commissioner, 18 T.C. 836 (1952), aff'd, 207 F. 2d 600 (C.A. 2, 1953), rev'd on other grounds, 348 U.S. 187 (1955).[1/] As we pointed out in our opening brief

1/ The Tax Court's recent decision in Estate of Webster v. Commissioner, 65 T.C. 968 (1976) did not reaffirm the principles in Estate of Sternberger as the estate mistakenly states. (Br. 11-12.) Relying on this Court's decision in Estate of Smith v. Commissioner, 510 F. 2d 479 (1975), cert. denied sub nom. Lowe v. Commissioner, 423 U.S. 827 (1975), the Tax Court in Webster held that interest expenses on loans made during decedent's lifetime were deductible as administration expenses because: (1) they were allowable under local law; and (2) they were necessarily incurred in the administration of decedent's estate. 65 T.C., pp. 979-982.

brief (pp. 21-22), however, Sternberger was overruled by this Court's decision in Estate of Smith v. Commissioner, 510 F. 2d 479 (1975), cert. denied sub nom. Lowe v. Commissioner, 423 U.S. 827 (1975), to the extent Sternberger makes allowability under local law the sole criterion for a federal deduction. In Smith, this Court--in holding that sales expenditures incurred by the executors on behalf of a testamentary trust were not deductible estate administration expenses--stated that the federal courts are not precluded from reexamining a lower state court's allowance of administration expenses "to determine whether they were in fact necessary to carry out the administration of the estate or merely prudent or advisable in preserving the interests of the beneficiaries." 510 F. 2d, p. 482-483. We submit that the estate's position here is contrary to this Court's decision in Estate of Smith and the controlling federal legal principles, and should not be followed.

Furthermore, as we indicated in our opening brief (pp. 15, 18-20), the facts here present a stronger case for disallowance than did those in Smith because here no local court has approved the expenditures, and both federal law and New York law characterize them as trust administration expenses, rather than as estate administration expenses. Here, title to decedent's rental properties passed under the residuary clause of the will directly to the residuary beneficiary, without any act on the part of the executrix. Matter of Salomon, 252 N.Y. 381, 169 N.E.

616 (1930). Thus, the trust held title to the rental properties under New York law, subject only to the power of sale in the executrix should there be a need to exercise the power for any estate need. Drake v. Price, 5 N.Y. 430 (1851); Matter of Tenney, 74 Misc. 2d 552, 554, 345 N.Y.S. 2d 406, 408 (Sur. Ct., 1973). Since the estate had sufficient cash to pay all of its debts and taxes after the sale of the Melville Street property, the additional two sales were clearly not necessary for the settlement of the estate, but simply reflected the judgment of the trustee about the management of its trust property. Estate of Smith v. Commissioner, supra; Estate of Carson v. Commissioner, P-H Memo T.C., par. 76,073 (1976); Payne v. United States, 35 A.F.T.R. 2d 1623 (M.D. Fla., Mar. 6, 1975).[2/]

Ignoring the foregoing, the estate argues (Br. 12) that the instant expenditures are allowable under New York law as estate administration expenses because it was "reasonable and proper" for the executrix to incur the selling expenses in that capacity.

2/ In Payne, the estate sought an administration expense deduction for expenditures incurred in connection with the sale of certain real estate owned by the decedent at the time of her death. By the terms of decedent's will, the realty involved was devised to decedent's son in trust for the benefit of decedent's grandchildren. And just as in the instant case, the estate in Payne had sufficient cash to pay all of its debts and taxes, and there was no evidence in the record to indicate that the sale was necessary to preserve the estate or effect distribution. Relying on this Court's decision in Estate of Smith, supra, the District Court concluded that the expense was "not one involving administration of the estate of all, but rather that it was undertaken in the interests of the beneficiaries of the trust." 35 A.F.T.R. 2d, p. 1626. The facts in Payne do not differ in any material respect from those in the instant case. Indeed, the parties here stipulated (R. 25-26) that the properties were sold at the request of the trustee, and we have already shown that title to these properties had already vested in the trust at the time of their sale.

Estates, Powers and Trusts Law (EPTL), McKinney's Consol. Laws of N.Y. Ann., § 11-1.1 (b)(23), Appendix, infra. This argument ignores the fact that the rental properties had already vested in the trust under New York law long before the sales were made. Moreover, the fact that the executrix was the one who actually sold the properties is clearly not controlling, since the properties were sold at the request of the trustee and since, contrary to the estate's contentions (Br. 12), an executrix is authorized to sell property owned by a trust under New York law. EPTL Sec. 11-1.1 (b)(5)(B), Appendix, infra.

2. The estate is also mistaken in its contention (Br. 10) that New York law no longer requires an administration expense to be "necessary" in order to be allowable. As this Court noted in Estate of Smith, the legislative history to the New York statute relied upon by the estate--EPTL Sec. 11-1.1 (b)(23)--indicates that the "necessity" standard in the prior New York law has been incorporated in the current law. 510 F. 2d, p. 481, fn. 1. But more importantly, the New York statute makes no clear distinction between the actions taken by executors and those taken by testamentary trustees. As we indicated in our opening brief (pp. 18-19), it is necessary to turn to New York case law for standards for distinguishing between executorial and trustee duties. Specificially, the duties of the executor are to take possession of the estate, "to collect the outstanding debt and

sell the goods and chattels so far as is necessary to the payment of the debts and legacies" (emphasis added), to pay the debts and legacies, and to distribute the surplus; actions taken beyond these are taken in the capacity of trustee. Drake v. Price, 5 N.Y. 430, 432 (1851) (Judge Paige dissenting, subsequently approved by the court in Hurlburt v. Durant, 88 N.Y. 121 (1882)). Thus, it is clear that New York law still requires an estate administration expense to be "necessary" to the settlement of the estate to be allowable. This view is supported by the fact that the surrogate is empowered to allow only "reasonable and necessary expenses actually paid" by the executor upon the settlement of the account. (Emphasis added.) Surrogate's Court Procedure Act, McKinney's Consol. Laws of N.Y. Ann., § 2307(1), Appendix, infra.

In sum, the estate's position that the instant expenses are allowable under New York law as estate administration expenses is based upon a mistaken view of New York law, and ignores the crucial New York standards for distinguishing between the duties of executors and testamentary trustees. We submit that the expenses here are trust administration expenses under both New York and federal law, and hence, not the "type intended to be deductible" for federal estate tax purposes. United States v. Stapf, 375 U.S. 118, 130 (1963); Estate of Smith v. Commissioner, supra, p. 482, fn. 4.

3. The estate contends (Br. 13-14) that the sales were necessary within the meaning of the Regulations to effect distribution to the trust because the trustee did not wish to accept the rental realty as a trust asset. See § § 20.2053-3(a) and 20.2053-3(d)(2), Treasury Regulations on Estate Tax (1954 Code). However, as we have shown above, title to these properties had already vested in the trust under New York law long before the sales were made by the executrix on behalf of the trust. Matter of Tenney, supra. Thus, there was simply no need to sell the realty to effect distribution to the trust because the trust already owned the properties. Estate of Carson v. Commissioner, supra; Payne v. United States, supra. The sale was to accomodate the trustee's wishes, not to settle the decedent's estate.

4. The estate's remaining contentions (Br. 15-17) as to why the sales were necessary to effect distribution have little, if any, relationship to the actual facts and issues at bar. For example, its statement (Br. 16) that "It does not advance the resolution of this question to argue that the selling expenses were incurred for the benefit of the trust" ignores the point that this is the very question before the Court in this case. Estate of Smith v. Commissioner, supra, pp. 482-483.

In a similar vein, the estate's reliance (Br. 15-16, 18-19) on Pitner v. United States, 388 F. 2d 651 (C.A. 5, 1967), and Dulles v. Johnson, 273 F. 2d 362 (C.A. 2, 1959) is misplaced, since both of those decisions involved attorney's fees which were allowable under state law as administration expenses and incurred in unavoidable litigation essential to the proper settlement of the estate. And Commissioner v. Tellier, 383 U.S. 687 (1966), and Newi v. Commissioner, 432 F. 2d 998 (C.A. 2, 1970)--which deal with the standards for "ordinary and necessary" business expenses under Section 162(a) of the Code (26 U.S.C.)--have no bearing on the issue here. (Br. 16.)

Finally, we reemphasize the total lack of evidence in the record as to the factual necessity of the instant expenditures.[3/] It is well settled that deductions from the gross estate for administration expenses, as well as all other deductions under the Code, are matters of legislative grace with the burden squarely on the taxpayer to establish the amounts claimed. Helvering v. Taylor, 293 U.S. 507 (1935). We submit that the estate has failed in this task.

5. Relying on the Sixth Circuit's decision in Estate of Park v. Commissioner, 475 F. 2d 673 (1973), the estate argues

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3/ The estate also implies (Br. 13) that the sales were made to preserve the estate, citing only the fact that the houses were old properties requiring maintenance and repairs. See Stip. par. 14. (R. 25.) We submit that this evidence is insufficient to support such a theory.

that Regulations Section 20.2053-3(d)(2) is invalid if it is construed to disallow the instant expenses. (Br. 17.) The same argument was rejected by this Court in Estate of Smith, supra, and the estate has offered no compelling reason why it should be accepted here. Moreover, Park is factually distinguishable from the instant case, since in Park the Sixth Circuit placed major reliance on the fact that the expenses were allowed by the Michigan probate court (475 F. 2d, p. 676), while in this case the expenditures--which may well be viewed as trust administration expenses under New York law--have yet to be submitted for approval to the surrogate in any characterization. (R. 73.)

The standards for reviewing Treasury Regulations are well settled. The Secretary of the Treasury has broad authority to establish Regulations under Section 7805(a) of the Code, Appendix, infra, and the courts have uniformly stated that such Regulations must be sustained unless "unreasonable and plainly inconsistent" with the statute. Commissioner v. South Texas Co., 333 U.S. 496, 501 (1948). Here, the term "administration expenses" is not defined in the statute, and it is not self-defining. Accordingly, the regulation in question "represents an effort by the Commissioner to supply the definitions that Congress omitted" and is "prima facie proper, comporting as * * * [it does] with the ordinary understanding" of the term "administration expenses." Bingler v.

Johnson, 394 U.S. 741, 749, 951 (1969). The estate does not, and indeed we submit could not, contend that the Regulation here is "unreasonable." Furthermore, the Regulation has been in effect in substantially identical language since 1919[4/] and is thereby "deemed to have received congressional approval and have the effect of law." Helvering v. Winmill, 305 U.S. 79, 83 (1938).

6. Finally, the estate argues (Br. 17-19) that the issue at bar is a question of fact to which the clearly erroneous rule applies. This argument, however, ignores the point that the facts here--all of which were stipulated by the parties (R. 20-26)--are undisputed. Rather, the dispute centers around how these facts should be characterized for federal estate tax purposes, and that, we submit, is plainly a legal question. Cf. Trust of Bingham v. Commissioner, 325 U.S. 365, 371 (1945).

It is the position of the Commissioner in the case at bar that the Tax Court misapplied the controlling legal principles of this Court's decision in Estate of Smith v. Commissioner, supra, to the undisputed facts of the instant case. Accordingly, we submit that Smith is controlling here and that the Tax Court's conclusion (R. 79-80) that the additional sales were necessary within the meaning of the Regulations to effect distribution to the trust is erroneous as a matter of law.

4/ See Treasury Regulations 37 (1918 Revenue Act), Arts. 41, 44.

We submit that there are no facts in the record which differentiate the instant case from the essentially similar executor-trustee arrangement existing in Estate of Smith. Indeed, the only factor that the estate points to in attempting to distinguish the two cases is Judge Forrester's ruling (R. 77) that decedent's will, unlike the will in Smith, did not contemplate an "in kind" distribution of the properties to the trust. Contrary to the estate's contention that this is a "finding" (Br. 15, 18) we submit that Judge Forrester's ruling on this point clearly involves an interpretation of decedent's will, which are matters of law under New York jurisprudence, and are thus freely reviewable by this Court. Matter of Scott, 8 N.Y. 2d 419, 426, 171 N.E. 2d 326 (1960); 95 C.J.S., Wills, Sec. 632. (Moreover, as we indicated in our opening brief (pp. 13, 23), this interpretation of decedent's will is in error, since a close examination indicates that, like the will in Estate of Smith v. Commissioner, 57 T.C. 650, 661 (1972), the will here did contemplate an "in kind" distribution of the properties to the trust.[5/] (R. 62.) But even if the properties were not specifically devised, we submit that such distinctions are irrelevant to the issue at bar--namely whether it was necessary to sell the properties to settle the estate. Estate of Smith v. Commissioner, supra, p. 483.

5/ The Tax Court made a similar error in its attempt to "distinguish" Estate of Swayne v. Commissioner, 43 T.C. 190 (1964), as we indicated on page 24 of our opening brief.

CONCLUSION

For the reasons stated above and in our opening brief, the decision of the Tax Court should be reversed.

Respectfully submitted,

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SEPTEMBER, 1976.

CERTIFICATE OF SERVICE

It is hereby certified that service of this reply brief has been made on opposing counsel by mailing four copies thereof on this 21st day of September, 1976, in an envelope, with postage prepaid, properly addressed to him as follows:

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 7805. RULES AND REGULATIONS.

(a) Authorization.--Except where such authority is expressly given by this title to any person than an officer or employee of the Treasury Department, the Secretary or his delegate shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

* * *

Estates, Powers and Trusts Law, McKinney's Consol. Laws of New York Ann.

§ 11-1.1 Fiduciaries' powers

(a) As used in this section, unless the context or subject matter otherwise requires, (1) the term "estate" means the estate of a decedent; (2) the term "trust" means any express trust of property, created by a will, deed or other instrument, whereby there is imposed upon a trustee the duty to administer property for the benefit of a named or otherwise described income or principal beneficiary, or both. * * * (3) the term "fiduciary" means administrators, executors * * * and trustees of express trusts * * *.

(b) In the absence of contrary or limiting provisions in the court order or decree appointing a fiduciary, or in a subsequent order or decree, or in the will, deed or other instrument, every fiduciary is authorized:

* * *

(5) With respect to any property or any estate therein owned by an estate or trust, except where such property or any estate therein is specifically disposed of:

* * *

(B) To sell the same at public or private sale, and on such terms as in the opinion of the fiduciary will be most advantageous to those interested therein.

* * *

(23) [renumbered as of June 22, 1973 as (22)]. In addition to those expenses specifically provided for in this paragraph, to pay all other reasonable and proper expenses of administration from the properly of the estate or trust, including the reasonable expense of obtaining and continuing his bond and any reasonable counsel fees he may necessarily incur.

* * *

Surrogate's Court Procedure Act, McKinney's Consol. Laws of New York Ann.

§ 2307. Commissions of fiduciaries other than trustees

1. On the settlement of the account of any fiduciary other than a trustee the court must allow to him the reasonable and necessary expenses actually paid by him * * *

* * *